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SENSITIVE

PASS NSC FOR JOSE CARDENAS, ROD HUNTER
PASS USTR FOR SUE CRONIN AND MARY SULLIVAN
TREASURY FOR MATT MALLOY
USDOC FOR 4322/ITA/MAC/OLAC/PEACHER AND SABOTTA

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SUBJECT: Managed Mercosur Auto Trade

Ref: Buenos Aires 831

Summary

¶1. (U) Argentina's auto sector is roaring ahead, and 2007 is well on track to be the best in its history. The auto industry is a crucial pillar of the Argentine economy, bringing good jobs, technology transfer and innovation. Given the auto industry's importance and political sensitivity, the GOA has historically been reluctant to leave its future entirely to market forces. An integral part of the GOA's - and industry's - strategy has been the Mercosur managed auto trading regime. Argentina and Brazil, the only major auto producers in Mercosur (not including Venezuela), have a substantial managed auto and auto parts trade under this regime. Up until the early 1990s, Argentina's auto industry, like that of Brazil, was largely closed and protected. Since then, both nations have slowly opened these industries, engaged in successive managed trading regimes, and made substantial forward progress in trade and investment. The GOA prefers managed auto trade, fearing Brazil's potential to dominate regional production. Although there is no true free trade today in autos, and little prospect of it in the medium term, the Mercosur managed trade agreement has, according to many observers, played a fundamental role in sustaining Argentina's support for Mercosur over the years. END SUMMARY.

¶2. (U) HEADY TIMES FOR THE IMPORTANT ARGENTINE AUTO INDUSTRY, WHICH THE GOA WILL CONTINUE TO PROTECT. A strong Argentine economy, and growing and diversified exports, will likely propel the auto sector to its best year in history in 2007. The auto industry is well on track to produce 500,000 units and export 300,000 this year. The Argentine auto industry is an important and dynamic sector, with well-paying and high-skilled jobs, technology transfer, and is an important multiplier in the industrial chain, adding value and helping in the commercial balance (Reftel). For these reasons, the GOA has always been reluctant to leave the industry entirely to the market, and has engaged in varying amounts of state intervention.

In fact, the auto industry has always been one of the obstacles to the stated liberal and integrationist goals of Mercosur.

¶3. (U) UNTIL EARLY 1990S, ARGENTINA AND BRAZIL PROTECTED DOMESTIC AUTO INDUSTRIES; HAVE COME A LONG WAY SINCE. Argentina and Brazil largely protected their domestic auto markets through the early 1990s with a mix of quotas, high tariffs and subsidies, as a part of their import substitution industrialization schemes. With the advent of Mercosur in the early 1990s, the major Mercosur partners slowly began to open their auto and auto parts trade. Given the political sensitivity that emblematic auto production holds for both nations, progress has been uneven. However, liberalization has come a long way: auto sector trade today constitutes about 18% of total intra-Mercosur trade, and Argentina-Brazil auto product trade in 2006 totaled over \$4 billion. Argentina and Brazil are the principal members of Mercosur and its main auto producers. (Note: Venezuela, still pending member state ratification of its accession to full member status, also produces automobiles. End Note). Argentina and Brazil have had a managed trade regime in autos and auto parts for several years. Argentina has also enacted several new and important auto trade agreements with Mexico, Venezuela, Chile, Uruguay and the European Union, among others. This extra-Brazil auto trade has been an important factor in Argentina's auto export diversification strategy.

¶4. (U) ASYMMETRIES THE KEY ARGENTINE CONCERN. Disparities in relative competitiveness are Argentina's biggest concern about free trade in autos. These concerns relate to Brazil's larger domestic market, scales of production, broader consumer base (and consequent ability to sustain new car models), and longstanding policy of a promoting industrial development with subsidies and incentives from national, state and local governments. Current account disequilibria following from the Brazilian devaluation of 1999 and the Argentine devaluation of 2002, have contributed to GoA hesitation to further liberalize its trade regime.

¶5. (U) FREE TRADE HELD OFF BY ARGENTINA. As originally envisioned in earlier Argentine/Brazil auto trade agreements, the Mercosur trade bloc would eventually move towards free trade in autos. However, Argentina over the years has resisted moves toward full free auto trade, fearing domination by Brazil's economy and auto market, both about four times the size of Argentina, and with whom it has a large auto trade deficit. Brazil's share of the Argentine auto market also dwarfs Argentina's market share in Brazil. Over the last decade, the two countries' successive bilateral managed and balanced auto trade agreements were done to assuage mostly Argentina industry concerns.

¶6. (U) THE HISTORY OF ARGENTINE/BRAZIL MANAGED AUTO TRADE PACTS: The 1991 Treaty of Asuncion and the 1994 Protocol of Ouro Preto both included "compensated trade" language that provided a basis for later managed auto trade regimes. Other agreements in the 1990s furthered this process, setting baselines on a common external tariff, less distortionary incentives, import regimes for parts and autos, and regional content indices. These agreements, although hardly revolutionary, had remarkable impacts on the industries, with investment, production and trade registering strong gains. For Argentina, from 1990 to 1998, production quadrupled (as a result of increased investment), and exports went from 1% of production to 55%.

¶7. (U) Under the 2000-2006 Mercosur auto agreement, Brazil was permitted to export \$265 of duty free products to Argentina for every \$100 of duty free Argentine exports to Brazil. Before this accord expired in July 2006, the two sides agreed to an updated agreement, to run from June 2006 to December 2008. This deal lowered this offset, the amount of automotive products that Brazil-based firms may export tariff-free to their Argentine affiliates, at \$195 for every \$100 of automotive products it imports from Argentina. But distinct from the previous agreement, it does not contain any Argentine local content requirement. To be treated as originating in Mercosur, vehicles and auto part assemblies must incorporate at least 60 percent parts manufactured in Mercosur. This latest 2006-2008 managed trade deal represented another breather for Argentina's manufacturers. With a move towards more liberalized trade, the Argentine automotive industry would have faced acute competition due to the strength of Brazilian auto imports. This deal gave local industry room to devise strategies to

counter any possible move towards more liberal trade after 2008. However, most industry analysts expect that a managed trade regime, in some form or another, will be extended for the foreseeable future.

¶18. (SBU) MERCOSUR AUTO TRADE NOT TRIMS CONSISTENT. In 1995, Argentina notified measures inconsistent with its obligations under the WTO Agreement on Trade-Related Investment Measures (TRIMS), dealing with local content and balancing trade flows in the automotive industry. Proper notification allows developing country WTO members to maintain such measures for a five-year transitional period, which ended January 1, 2000. In November 2001, the WTO granted an extension to the TRIMS transitional period, allowing Argentina and several other countries to maintain TRIMS-inconsistent measures until December 31, 2003. Article 23 of the September 2002 bilateral auto pact between Argentina and Brazil allowed Argentina to maintain minimum domestic content requirements on vehicles manufactured in Argentina until 2005. Article 13 of the same agreement established trade balancing measures which expired in 2006, and were extended through 2008, including the local content and trade balancing clauses.

¶19. (SBU) MULTINATIONAL AUTO COMPANIES, FORD AND GM INCLUDED, HAVE ADAPTED WELL. Argentine auto producers have adjusted well to the Mercosur regime. In fact, most observers here say that the accords have provided some amount of predictability to the market, and they can plan their Mercosur and beyond auto and parts production strategies accordingly. GM, Ford, Toyota, VW, Renault and Peugeot all have trade in line with this Mercosur trade regime between Argentina and Brazil, with only Fiat manufacturing only in Brazil. (In 2008, Fiat is set to again produce cars in Argentina.) Analysts will note further that the proof is in the numbers: for 2007-08, the industry plans \$720 million in investments, there are new models and plants being planned, and other players, including the Chinese, are planning their entries as well.

¶10. (SBU) COMMENT: ALTHOUGH THE MERCOSUR AUTO TRADE REGIME MAY NOT BE IDEAL, IT HAS ITS SUPPORTERS, AND HAS HELPED KEEP MERCOSUR TOGETHER. By most Argentine accounts, the Mercosur managed auto trade regime has fulfilled its objectives. These are good times for the regional auto trading regime and the regional auto market in general. Production and exports, with their corresponding investment and employment in Argentina, are big plusses. However TRIMS-inconsistent and contrary to classic trade theory this trade regime may be, managed trade in autos has clearly been seen here as politically and economically a big positive. For local auto producers, it has been an easy adaptation. In fact, managed trade in autos has been seen by some as a welcome relief, providing consistent rules by which to operate -- an anchor of sorts -- in a nation criticized for lacking clear and consistent regulatory regimes and a difficult investment climate. This agreement has not been good only for the auto industry proper, but its indirect beneficiaries and providers: the dozen-odd other industries which support the industry, providing electricity, glass, plastic, metals, tools, machinery, rubber and upholstery. Many analysts have commented that in some ways, what Mercosur has failed to achieve in a larger sense (a true customs union, stability, clear rules), the managed auto trade regime has achieved in a smaller sense. Perhaps more importantly, in the view of many observers, managed trade, with the ability to attenuate variations in the relative competitiveness of the two markets, has helped ensure continued local production and investment, and has been politically helpful for the continued viability of Mercosur.

¶11. (U) To see more Buenos Aires reporting, visit our classified website at: <http://www.state.sgov.gov/p/wha/buenosaires.>

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